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WEST BANK/GAZA - CREDIT GUARANTEE
FEASIBILITY

FINAL REPORT

JUNE 16, 1989

Price Waterhouse



June 16, 1989

Mr. Gary Vaughan
ANE/PD/MENA
U.S. Agency for International
Development
Room 3327A, New State
320 21st Street, NW
Washington, DC 20523

Dear Mr. Vaughan:
Re: Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
West Bank/Gaza - Credit Guarantee Feasibility

Enclosed please find three copies of our Final Report of the West Bank/Gaza - Credit Guarantee Feasibility, as prepared by Mr. Maurice F. Claeys and reviewed by Price Waterhouse, Prime Contractor under FSDP. One additional copy has been forwarded to Sandra Frydman, AID/PRE/PD.

It has been a pleasure to work with USAID on this important feasibility study. We look forward to working with you again in the future as your plans for new projects in the financial sector develop.

Very truly yours,

Price Waterhouse

attachments



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I. BACKGROUND

The Asia Near East (ANE) Bureau, in cooperation with the U.S. Embassy in Tel Aviv and the Consulate General in Jerusalem, sought the services of a U.S. consultant to explore the potential feasibility of a credit guarantee scheme in the West Bank and Gaza (WB/G), particularly in view of the limited credit facilities available to small and medium-sized Palestinian businesses. As such, the objectives of this engagement included:

- o To determine the potential for designing during FY 1989 a credit or credit guarantee mechanism to serve small and medium-sized Palestinians in the West Bank and Gaza.
- o To assess the present and prospective capability of indigenous Palestinian financial institutions in WB/G, and suggest follow-on areas of inquiry/investigation in this area.

The scope of work for this task order is being carried out under AID/PRE's Financial Sector Development Project (FSDP). (See Appendix A for a copy of the Scope of Work). Mr. Maurice F. Claeys was contracted to carry out the engagement. Mr. Claeys spent over one week in country and carried out a number of interviews with representatives of the banking sector, the private sector and government (see Appendix B for a list of interviewees). He briefed AID officials prior to leaving the West Bank/Gaza, as well as upon his arrival in Washington, D.C. The Draft Final Report was prepared by Mr. Claeys and reviewed by Price Waterhouse, Prime Contractor under FSDP. This final report incorporates the consultant's response to comments from AID/ANE/PD and was reviewed by Price Waterhouse in its capacity as prime contractor.

Chapter II presents a summary of findings and conclusions. Chapter III, in turn, presents details regarding the state of financing in the West Bank and Gaza, and includes a discussion on the economy, the business environment, present financial services, small business and farmers, large businesses, the future of the West Bank and Gaza, and interim possibilities with respect to financing small and medium-sized Palestinian businesses.

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II. CONCLUSIONS AND RECOMMENDATIONS

The West Bank and Gaza's economy is seriously constrained by the political and security situation. They are occupied by a military force with the objective of maintaining security and supporting Israel's economic interests. At the present time, there is no demand for long-term credit for the expansion of larger companies that are operating reasonably well in the West Bank and Gaza, but there continues to be a demand for short-term credit by small industries and merchants.

The proposed USAID/Jordan program of guaranteeing loans made in the West Bank and Gaza by the Cairo Amman Bank has a high probability of success. As such, it is suggested that a lending program implemented through the Amman Bank be pursued and monitored very closely by USAID/Jordan. If it is successful after an initial trial period of six months to a year, the program could receive the support of an additional loan guarantee by PRE/I, or directly through the CONGEN in Jerusalem. If the signing of the USAID/Jordan program is delayed for more than sixty days, it is suggested that the loan guarantee program be implemented directly through the Nablus branches, by-passing the political entity of Jordan.

In addition to the loan guarantee program above, there are a number of "ad hoc" financing and other financial-related arrangements having a reasonably high probability of success that could also have an important impact in the West Bank and Gaza. These include:

- o A letter of credit arrangement using American banks to reduce the cost and otherwise facilitate the importation of mother of pearl from Australia by local artisans
- o Assisting in expanding the use of the Save the Children Project beyond the farming sectors
- o Lease programs for refrigeration equipment, and honey producers in Jericho.

During the course of all the interviews, it became clear that the overriding risk faced by Palestinian entrepreneurs is primarily political, not economic. The ability of the

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entrepreneur/borrower to succeed in the use of credit will depend heavily on whether the legal and political climate permits him to operate his business on reasonably equal terms with all competitors.

West Bankers and Gazans are committed to survive in a very difficult environment. Credit extended to the Palestinians on very clearly defined terms and conditions similar to the Save the Children Project have shown excellent results. The consultant feels confident that a similar small business lending and guarantee program, managed by professionals who understand small business and the principles of cash-flow lending, can be highly successful from a repayment standpoint, and can have a positive impact on the economy of the West Bank and Gaza.

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III. FINANCING IN THE WEST BANK AND GAZA

A. The Economy

The West Bank is an area of contested political borders which, including Gaza, has a population of about a million and a half people. The court system is Jordanian. However, most individuals interviewed, with the exception of a few bankers, indicated that the court system was essentially inoperative. While at one time the Jordanian dinar was the official currency, the Israeli shekel and the dinar are now equally acceptable.

The operative government is essentially the military government of Israel, and the local governments, while operating, are poorly funded. For example, the mayor of Jericho indicated that his funding is limited to local fees and monies flowing from Arab countries. Merchants operate only in the mornings, and most retailers are closed in the afternoon. Strikes, which may extend from the small merchants to the whole economy, including the transportation sector, are called periodically by the Palestinian youth. This is the economy with which industry and merchants of the West Bank must deal.

In evaluating the economy from a macro point of view, the data is highly suspect. The best data available seems to be extrapolated from surveys of 1978 and 1982, supported by limited on-site visits--twenty-five by the Management Development Study and fifteen by the West Bank Database Project. The statistical comparisons do not always take into consideration changes in political borders. Given the environment of the West Bank, surveys are highly suspect. The statistical abstract of Israel estimated that, in 1981, there were ten enterprises with employees of fifty or more people in 1980, and twenty-eight enterprises with twenty to forty-nine employees. These figures are mentioned only to indicate the limited size of industry in the West Bank. Based on visits and conversations with bankers and industrialists, it is estimated that the actual number of enterprises is larger than indicated in prior studies. In any case, there seems to be little question that the economy of the West Bank and Gaza is a stagnant, provincial, and under-developed economy with the greatest developmental factor being the large migratory workforce that commutes to Israel.

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B. The Business Environment

It was stated several times during interviews that Israel does not allow Arab firms from the territories to market goods via Israel to overseas destinations. However, this type of activity was actually being carried out by some of the companies interviewed. It is obvious that industrialists are caught between the conflicting, competing influences of Israel and Jordan. The military administration of Israel is in charge not only of insuring security, but also of protecting Israel's economic interests. By the same token, shipping through Acaba, Jordan, is very costly and subject to a number of arbitrary factors. One industrialist indicated that shipping to Amman, Jordan, which is about 100-150 miles away, costs the same as shipping to London.

In 1978, a USAID study list the following factors as delaying industrialization:

- o Political uncertainty
- o Limited domestic market for domestic products due to low purchasing power
- o Lack of effective entrepreneurs with an unwillingness to invest capital
- o Out-of-date technology
- o Low levels of education and vocational training
- o The absence of complementary services and developed infrastructures including electricity
- o Lack of adequate natural resources which results in an increase in the import of raw materials.

These conditions still exist.

The combined weight of not having their own economic administration, the restrictive and arbitrary practices of Israel and Jordan, the overwhelming dominance of the Israeli economy and the presence of a military administration all act together to greatly limit the potential for economic and industrial development in the territories.

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The merchants are nevertheless operating in this environment. Some industries are experiencing a greater level of activity because of increased nationalism and the desire of Arabs to buy local products. The small farmer, because of this desire on the part of the population to purchase local products, is doing particularly well.

Although the business climate in the West Bank is very difficult, the environment in the Gaza is significantly worse. Transfer of workers and merchandise in and throughout Israel are more difficult from Gaza than the West Bank. Moreover, banks are closing offices in Gaza while attempts were being made to open branches in the West Bank.

C. Present Financial Services

In order to assess the present financing needs of industry, a number of visits were made, including to:

- o Ten banks and branches
- o Four industries
- o Two money changers
- o Five private voluntary organizations which are either lenders or grantors
- o One combination private volunteer organization and industry
- o Two management aid or study program operations.

As a result of these interviews, it became readily apparent that the large, entrenched businesses consider the political environment to be much more of a problem than the credit environment. In fact, they do not perceive a shortage of loan or credit facilities. The political environment since 1967 has been one of the application of Jordanian laws and currency, combined with Israeli military control. The municipalities are not adequately funded, the courts work but are under the influence of the military, and the military government of Israel manages the situation so as to maintain peace and economic advantage for Israel. In this environment, most large firms are content to maintain a low-debt structure because, in the face of strikes and

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harassment, they are able to close down their companies without facing the overhang of interest or debt payments.

D. Small Businesses and Farmers

There nevertheless continues to be a need for short-term credit by merchants and small industries. Small businesses are being financed in small amounts (up to about \$10,000) by a combination of banks and money changers. It was reported, however, that on a couple of occasions the money changers have run out of lendable funds. In addition, the Israeli banks are acting cautiously, and are making small loans at very high rates of interest.

The branch managers of Cairo Amman Bank indicated that they have taken over the position of the money changers with respect to making small loans to business. Based on conversations with businessmen and branch managers of Cairo Amman, credit is being extended at a high cost to small businesses on a very selective, fully-collateralized basis. There were no indications that these branches attempt to analyze the cash flow of small businesses to determine their ability to repay. Rather, the loan decision is predicated on the existence of co-signers and sufficient collateral, as well as the position of the borrower in the community/family, etc.

A description of a discussion with a Palestinian bank manager in Bethlehem serves as an example of the type of financing needed in the region. The local artisans need mother of pearl from Australia for the manufacture of rosaries and other items that they sell to the tourists. At the present time, in order to obtain a letter of credit for the importation of mother of pearl, the artisan must deposit cash collateral of sometimes up to 115 percent of the letter of credit, pay 40 percent interest on the letter of credit outstanding in addition to letter-of-credit fees of about 2 percent. Because of these high costs, the artisans import in \$1,000 lots, as opposed to the \$10,000 lots they imported in the past. If, for example, a system could be devised whereby, say, an American bank could confirm or issue letters of credit to the Australian exporter, the exporter could ship directly to the Bethlehem artisan and the cost to the artisan would be considerably less.

This type of financing arrangement was brought to the attention of the branch manager as a viable alternative for

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import finance. It was noted, however, that the transaction would require that someone make the credit evaluation of the Bethlehem artisan to determine his ability to repay. The branch manager offered to make that credit evaluation, even though his own bank would not be the issuer of the letter of credit. He thought his home office would approve such an arrangement because he would maintain the checking account of the artisan and be able to charge for other services. This is the sort of "ad hoc" arrangement that could be devised if there were an intermediary through which the negotiations for the letter of credit to the Australian exporter could be negotiated and implemented.

There is a possibility that the LPG could be used to support a letter of credit issued through a local bank and a bank in New York, for example. However, since foreign risk is involved in this transaction, in addition to significant country risk, it may be difficult to find an offshore bank willing to confirm the letter of credit of a local bank, such as the Cairo Amman Bank. Nevertheless, it may be possible, if the Cairo Amman bank has sufficient corresponding balances in one of the New York banks, to convince the New York bank to confirm 50% of the letter of credit with the balance guaranteed by AID. This would require a significant amount of negotiation, but the consultant feels it can be done.

Farmers seem to be obtaining credit in small amounts from a number of lending agencies. By far the best program seems to be the Save the Children Program for small farmers and agricultural-related businesses. Since starting operations two years ago, about \$250,000 in loans have been granted to farmers, averaging about \$3,500 per loan. Seventy-one loans were made before Israel closed down the operation several months ago. Of the seventy-one loans, fifty-one were made in Gaza, all of which were paid back. At the present time, there is only about \$10,000 in loans outstanding, and there is no question in the minds of the Save the Children Project representatives that all loans will be paid back in a timely manner.

The Government of Israel authorized the reopening of the program a few weeks ago and, since that time, sixteen loans totalling about \$55,000 have already been made. This program's 100 percent repayment rate is outstanding. From a developmental point of view, the program is equally impressive in that it was able to disburse over \$250,000 in small loans in such a short period of time.

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The Save the Children Project is now considering expanding its operations to include small businesses. The Project has been very successful in the farm sector because its representatives understand farming, and have thoroughly analyzed the operations of each prospective loan recipient. Until Save the Children is in a position to make that same type of detailed analysis of other types of borrowers, one would expect that their credit experience would not be quite as good. It would be appropriate, once there is a small business lending program in the West Bank, to have representatives from Save the Children attend a Management Advisory System seminar on small business lending. Furthermore, it is suggested that Save the Children use the cash-flow forms used in the management advisory systems seminars as an aid in its representatives' analysis of the cash flow needs of small business.

E. Large Businesses

There is a limited number of large businesses in the West Bank and Gaza, and all appear to be adequately financed at this time. The few companies that were visited indicated that they had no need for additional credit, and felt confident that their strategy to limit their debt exposure was a distinct advantage in view of the present economic environment.

F. The Future of the West Bank and Gaza

Few of those interviewed would speculate as to the economic environment which would be operative should "normalcy" return. The West Bank and Gaza is not a typical developing country environment. The entrepreneurs are fairly refined in finance (although in the opinion of the consultant they may be overly foreign-exchange oriented, as opposed to credit oriented, like business persons in the United States). When normalcy returns, it is assumed that additional bank branch licenses will be permitted and that bank credit will expand. Tribal or family traditions will undoubtedly continue to limit business growth as we know it in the United States. But credit terms will be more favorable for those with the proper family connections depending, of course, on the money-supply situation in the future economy. It may be that there will be sufficient competition so that the banks will be more inclined to extend credit. If that were the case, and assuming proper training in cash flow-based lending, it is conceivable that new businesses, regardless of family connections, will have access to adequate levels of financing. The Palestinian is an industrious individual and, though cautious

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on the amount of credit he will assume, will entertain debt if there is reasonable assurance of repayment and profit to be gained by incurring additional debt.

In comparison with other developing countries, there is no question that there is a shortage of financial institutions in the West Bank and Gaza. As indicated above, once the situation becomes more normal, there will undoubtedly be an increase in the number of banks in the region. While the West Bank has generally been a capital exporting area, that may very well have been due to the political environment in which it had been operating for many years. Nevertheless, there is a need for an expansion of other financial institutions, such as investment companies. But this is a long-range need.

One of the more interesting visits was one held with two money changers who were considering an expansion of their current lending facilities for small merchants. They suggested that if they could get ten to fifteen money changers that would commit between \$100,000 and \$200,000 apiece, they could form an investment company. They were encouraged to do so and were offered some assistance in how to incorporate such an investment company. But it was suggested that they had to prove themselves before credit would be extended to them to improve their leverage. They seemed positive about the idea, and it may very well prove to be a good concept should the situation become more normal in the future.

G. Interim Possibilities

In the present political and economical environment, it is inconceivable that any large business would assume long-term debt in order to expand operations. This was confirmed by the four large industries that were visited. By the same token, there is a need for a more competitive lending environment for small businesses which include small factories and retail merchants. The money lenders are effective lenders in the present environment and, apparently, the Israeli bank branches are making some credit available. It does not seem likely, however, that USAID can work with the Israeli bank branches or with the informal structure of the money changers. Therefore, the only possibility is the expansion of Cairo Amman's facilities in the West Bank.

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The Cairo Amman branch managers, other than Nablus, are experienced bankers, but have limited experience in cash flow-based lending. In the present environment, they are under tremendous pressure from their head office to be extremely cautious in any lending activity. Cairo Amman, for example, must maintain a 10 percent capitalization on deposits generated in the West Bank, and therefore is going to be extremely cautious in exposing its capital position to a marginal loan program. Nevertheless, with a partial guarantee by USAID, the consultant sensed an interest in making funds available to small businesses on the West Bank, and indeed received a confirmation of that desire in conversation with Cairo Amman holders. While in Amman, Mr. Shukri stated that the Prime Minister was to sign the USAID/Amman agreement, and that he was committed to a lending program in the West Bank that would be signed directly by Cairo Amman Bank holders. That program would be implemented under the LPG program if for some reason the Prime Minister does not sign the USAID agreement.

In addition to the above program, there are possibilities to finance selective industries on an "ad hoc" basis. The Bethlehem artisan situation was discussed above. Another possibility for "ad hoc" financing involves West Bank retailers who would like to buy milk and soft drinks from West Bank suppliers. When they have discussed this possibility, the current Israeli suppliers have threatened to recall the refrigeration equipment presently on lease. This would make it impossible for the retailer to store milk of West bank origin. If a leasing arrangement could be financed for West bank distributors they could lease refrigeration equipment to the retailers, allowing the retailers to buy and safely store West bank products. A leasing program for refrigeration equipment for those retailers is a reasonable effort that could be extended by USAID if it were able to find an intermediary who would make the credit evaluations, and retain title to the refrigeration equipment that is on lease. A similar program could be made available for the honey cooperative of Jericho that now exports 100 percent of its output to Jordan. A similar leasing program through the Cooperative Development Program, on a very clearly defined basis, would be a very effective program for another sector of the economy.

APPENDIX A

SCOPE OF WORK FOR CLABYS TDY

Objectives:

1. To determine the potential for designing during FY 1989 a credit or credit guaranteed mechanism to serve small and medium-sized Palestinian businesses in the West Bank and Gaza.
2. To assess the present and prospective capability of indigenous Palestinian financial institutions in WB/G, and suggest follow-on areas of inquiry/investigation in this area.

Background:

ANE Bureau, in cooperation with Embassy Tel Aviv and the Consulate General in Jerusalem, is exploring the potential feasibility of a credit or credit guarantee facility in the West Bank and Gaza. AID currently has ongoing a Management Development Project (through a U.S. contractor, DPI) which provides technical assistance to small and medium-sized businesses in WB/G. However, there are few credit facilities available to small and medium-sized Palestinian businesses, especially given the presence of only one fully operational Arab bank in WB/G, Cairo-Amman Bank. Although some AID supported PVOs (e.g. Save the Children Federation's Revolving Fund) and other donors support some credit facilities, they are largely confined to very small industrial and agricultural enterprises.

The present scope of work would thus explore the potential for initiating a credit or credit guarantee facility which would meet the financing needs of small and medium-sized enterprises, similar to the universe of companies being served under the Management Development Project. If the contractor feels that more serious design of a credit facility is warranted, and depending on a review of any final design analysis (outside the scope of the current contract), PRE Bureau may consider such a project for possible funding under its planned LPG facility. The scope of work for this task order is being carried out under PRE's Financial Sector Development Project.

Tasks:

In carrying out the scope of work, the contractor will complete the following tasks:

-- Develop an understanding of existing and/or potential credit available to small-medium sized businesses in the West Bank and Gaza. This will include potential and existing indigenous and offshore informal and formal sources of credit.

-- Obtain a general idea of the types of credit and

other financial services most needed by WB/G Palestinian businesses and which are not being met (or not being met at reasonable cost) by existing banking institutions.

-- Identify and Review options and alternatives to increase the flow of credit to small and medium-sized Arab-owned business in the West Bank and Gaza.

-- Determine the potential for designing a credit facility for WB/G during FY 1988, and if a facility would appear to be feasible, outline the essential characteristics of such a facility (dollar size of facility, institutional participants, types of credit or credit guaranty agreements, sketch of the type of business demand to be served, financial terms and conditions of such a facility for AID, participant banks, and the Palestinian borrower).

-- If such a credit facility does not appear worth pursuing in FY 1989, the contractor will identify the principal constraints confronting such a facility, and any suggestions on how such constraints might be alleviated.

In carrying out the above tasks, the contractor will generally follow the travel and appointment schedule outlined below:

1. Arrive in Tel Aviv, and travel to Jerusalem (o/a February 22, 1989) where he will stay for the WB/G portion of the trip (approx. 7 working days). This leg of the trip would be devoted to the following:

-- Briefing and debriefing by appropriate U.S. Embassy and CONGEN/Jerusalem staff (Note: control officers for the trip will be Jake Waller, Economic Office, Embassy Tel Aviv, and Liano Dorsey, Political Officer, Consulate General in Jerusalem).

-- Meetings with and site visits to a representative sample of Palestinian businessmen in the West Bank and Gaza.

-- Meetings and site visits with branch managers of Cairo-Amman Bank (Medhat Kanaan) in the West Bank and Bank of Palestine in Gaza.

-- Meeting and site visit with principals of Bethlehem Finance Corporation, and any other appropriate indigenous or foreign business and financial interests in West Bank and Gaza.

2. Arrive in Amman, Jordan (via land crossing at the Allenby bridge) for approximately 2 work days to clarify any potential credit facility prospects/problems with Cairo-Amman Bank, or any other appropriate Jordanian bank. The contractor will also brief USAID/Amman's Project Development Office (William Riley) on the proposed facility and any contacts with

CAB or other banks.

3. Arrive in London, England for approximately 2 work days to further explore any off-shore bank participation in a possible credit facility, if such discussions would appear useful based on the credit facility mechanisms explored in WB/G.

At least 3
possible
Bank
parties

4. Arrive in Washington, D.C. (one working day) to verbally debrief the West Bank/Gaza Working Group (ANE Bureau) and appropriate PRE offices concerning the results of the trip.

5. Arrive in Seattle, Washington (one working day) and draft and complete two copies of a typed report for submission and review by ANE/PD/MENA (Gary Vaughan) and PRE/PD (Jim Dry).

Reports: The contractor will prepare a written report of approximately 5-10 pages which will convey the information gathered during the trip, conclusions reached about the feasibility of any credit facility, banking/business contacts made during the trip, and if any credit facility appears feasible, a brief sketch of the type of facility and how it would operate. The final report will be submitted to the West Bank/Gaza Working Group Project Manager for this activity, Gary Vaughan, ANE/PD/MENA (work telephone: 202-647-7896) and to Jim Dry of PRE/PD (work telephone: 202-647-7474), Project Manager of the Financial Sector Development Project, due no later than March 24, 1989.

draft: GLVaughan ANE/PD:2/15/89

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APPENDIX B- LIST OF PERSONS INTERVIEWED

BANKS

Haider Husseini- Arab Bank, Jerusalem

Mr. Abboud- Grindley's Bank (formerly Ottoman Bank)

Albert Noursi- British Bank of the Middle East

Hashem Ata Shawa- Bank of Palestine

Rushdi Sakallah- Bank of Palestine

Dr. Basil Shawa, Deputy Regional Manager, West Bank Branches- Cairo
Amman Bank, Ramallah

Medlack Kanan- Cairo Amman Bank, Nablus

Manager- Cairo Amman Bank, Hebron

Fayez Hazboun- Bank Leumi, Bethlehem

Gad Marx- Bank of Israel

Fawzan Shuriki- Cairo Amman Bank, Amman

GOVERNMENT AGENCIES

Nour Dajani- Jordan Deputy Minister of the Occupied Territories

INDUSTRIES

Lufti Rezk- Rezk Sons Limited, Gaza

Mahmoud Shurrab- Shurrab Industrial and Trading Company, Gaza

Issa Abua Itah- Jordan Plastics Company

William Shehadi- Bethlehem Bakery

Omar Hamad- Money Changer

PRIVATE VOLUNTARY ORGANIZATIONS

Christopher George- Save the Children Fund

Lance Matteson- Asia Near East Relief Agency (ANERA)

Omar Daboodi- Arab Development and Credit Company

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Ahbad Zghayyar- Arab Development and Credit Company

Mazen Dabbach- Arab Development and Credit Company

Hisham Awardani- ECG Economic Development

Phil Brown- CDP Cooperative Development Project

INDUSTRY PVO

Charles Shamas- Mattin Center for Productive Development

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